



STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

DRAFT

Date Introduced:	02/25/09	Bill No:	AB 676
Tax:	Sales and Use	Author:	Jeffries
Related Bills:			

BILL SUMMARY

This bill would provide that a qualified destination management company (DMC), as defined, is a consumer, rather than a retailer, of tangible personal property it provides to its client in a qualified contract, as defined, for destination management services. This bill would specify that these provisions are declaratory of existing law.

ANALYSIS

CURRENT LAW

Current law imposes a sales or use tax on the gross receipts from the sale of, or the storage, use, or other consumption of, tangible personal property, unless specifically excluded or exempted by statute. Under current law, gross receipts include all amounts received with respect to the sale of tangible personal property, with no deduction for the cost of the materials used, labor or service costs, or any other expenses of the retailer, unless a specific statutory exclusion applies. Moreover, gross receipts include any services that are a part of the sale. When sales tax does not apply, use tax is imposed and is measured by the sales price of property purchased from a retailer for storage, use, or other consumption in California. The use tax is imposed on the person actually storing, using, or otherwise consuming the property.

The Board's Sales and Use Tax Regulation 1603, *Taxable Sales of Food Products*, interprets and makes specific the sales and use tax law as it applies to businesses that sell meals, food, and drinks, such as bars, delis, restaurants, and catering operations. Regulation 1603 defines a caterer to mean a person engaged in the business of serving meals, food, or drinks on the premises of the customer, or on premises supplied by the customer, including premises leased by the customer from a person other than the caterer.

Regulation 1603 also specifies how tax applies to charges made by caterers with respect to their sales of meals, food, and drinks. Tax applies to the entire charge made by caterers for serving meals, food, and drinks, inclusive of charges for food, the use of dishes, silverware, glasses, chairs, table, etc., used in connection with serving meals, and for the labor of serving the meals, whether performed by the caterer, the caterer's employees or subcontractors. Tax applies to charges made by caterers for preparing and serving meals and drinks even though the food is not provided by the caterers.

Regulation 1603 (h)(3)(C), *Caterers Planning, Designing and Coordinating Events*, provides that tax applies to charges made by a caterer for event planning, design, coordination, and/or supervision if those charges are made in connection with the furnishing of meals, food, or drinks for the event. Tax does not apply to separately stated charges for services unrelated to the furnishing and serving of meals, food, or drinks, such as optional entertainment or any staff who do not directly participate in the

preparation, furnishing, or serving of meals, food, or drinks, such as coat-check clerks, parking attendants, and security guards.

Under the Sales and Use Tax Law, **event planners, including DMCs, are treated in a similar manner to caterers** when providing meals, food, and beverages as part of a given event. In this case, the event planners such as DMCs are making a retail sale of the meals, food, and beverages they provide and the sales tax is due on the gross receipts from such sales. Tax applies to the entire charge, including the charge for labor in planning or coordinating that part of the event, because the charges for such labor are regarded as charges for services that are part of the sale of tangible personal property.

Service Enterprises. In general, persons engaged in the business of rendering services are generally not considered retailers, but instead, are considered consumers of any tangible personal property incidentally transferred in the performance of their services. As consumers, tax applies to the service providers' purchase of any property used in the performance of their services.

The Board's Sales and Use Tax Regulation 1501, *Services Enterprises Generally*, provides that the basic distinction in determining whether a particular transaction involves a sale of tangible personal property or the transfer of tangible personal property incidental to the performance of a service is one of the true object of the contract; that is, is the real object sought by the buyer the service per se or the property produced by the service. If the true object of the contract is the service per se, the transaction is not subject to tax, even though some tangible personal property is incidentally transferred.

Under the Sales and Use Tax Law, the following service providers have specifically been deemed to be consumers, rather than retailers, of certain items that they use or furnish in the performance of their professional services:

- Optometrists, physicians and surgeons, and registered dispensing opticians with respect to ophthalmic materials for the treatment of conditions of the human eye. (Section 6018)
- Veterinarians with respect to certain drugs and medicines. (Section 6018.1)
- Chiropractors with respect to vitamins, minerals, dietary supplements and orthotic devices. (Section 6018.4)
- Podiatrists with respect to prosthetic materials and inlays in the diagnosis, treatment, or correction of conditions of the human foot. (Section 6018.5)
- Any person who receives 20 percent or less of his or her gross receipts from the alteration of garments during the preceding calendar year is a consumer of, and not a retailer with respect to property used or furnished by that person in altering new or used clothing, provided both of the following apply: 1) the person operates a location as a pickup and delivery point of garment cleaning, or provides spotting and pressing services on the premises, or operates a garment cleaning or dyeing plant on the premises; and 2) 75 percent or more of that person's gross receipts represent charges for garment cleaning or dyeing services. (Section 6018.6)
- Licensed hearing aid dispensers with respect to hearing aids. (Section 6018.7)
- Producers of x-ray films or photographs with respect to materials and supplies used for the purpose of diagnosing medical or dental conditions of humans. (Section 6020)

PROPOSED LAW

This bill would add Section 6018.9 to the Revenue and Taxation Code to provide that a qualified DMC, as defined, is a consumer of, and would not be considered a retailer of, tangible personal property it provides to its client pursuant to a qualified contract, as defined, for destination management services.

This bill defines a “qualified destination management company” to be an incorporated business entity that meets all of the following:

- Is substantially engaged in the business of providing destination management services. For purposes of this paragraph, “substantially” means 80 percent or more of the gross sales are derived from the business of providing destination management services.
- Is not doing business as a caterer.
- Maintains a permanent nonresidential office in California in which the destination management services are provided.
- Has three or more full time employees.
- Expends 1 to 3 percent of gross revenue, annually, to market California and local destinations for tourism.
- Does not own any equipment used to provide destination management services, including, but not limited to, dance floors, decorative props, lighting, podiums, sound or video systems, stages, or equipment for catered meals. This condition does not apply to office equipment used in the conduct of the entity’s business.
- Does not provide services for weddings.

This bill would define a “qualified contract” to mean a contract between a qualified DMC and its client for destination management services that meets all of the following conditions:

- 1) The client is a corporation, partnership, limited liability company, trade association, or other business entity principally located outside of the county in which the destination management services are provided. The client is not an individual, social club, or fraternal organization.
- 2) The client pays the qualified DMC for all the destination management services provided to the client.
- 3) The qualified DMC pays all the vendors that sell or lease tangible personal property to the qualified DMC for the contract services, including vendors’ charges for sales tax reimbursement or collection for use tax.
- 4) The destination management services occur in part, or all, of two or more consecutive days.

“Destination management services” would mean a combination of four or more of the following services:

- Transportation.
- Entertainment.
- Meals.
- Recreational Activities.
- Tours.
- Registration.
- Staffing.

The bill states it is the intent of the Legislature that Section 6018.9 be declaratory of existing law. As a tax levy, the provisions of the bill would become effective immediately upon enactment.

BACKGROUND

SB 1628 (Ducheny and Wiggins) and SB 700 (Ducheny), which were virtually identical to this bill, were introduced during the 2007-08 Legislative Session. SB 1628, as amended on May 19, 2008, was placed on the suspense file in the Senate Appropriations Committee. SB 700, as amended on May 16, 2007, died in the Senate Revenue and Taxation Committee.

COMMENTS

1. **Sponsor and purpose.** The sponsor of the bill is the Association of Destination Management Executives (ADME) who represents DMCs. According to the sponsor, the true object of a DMC's contract with its client is services, and any tangible personal property that is transferred to the client is incidental in the providing of those services. As such, DMCs want to be regarded as consumers, rather than retailers of any transferred tangible personal property under the Sales and Use Tax Law.
2. **What is the effect of this measure?** This bill would make a qualified DMC a consumer, rather than a retailer, of tangible personal property (most notably meals, food and beverages) it provides to its client in a qualified contract for destination management services. Therefore, a qualified DMC would not be liable for sales tax on its retail sales of food and beverages and other items related to the sale of food and beverages (e.g., centerpieces, flowers, candles, silk or papier mache flowers, ice sculptures), including any mark ups associated on these items. Moreover, DMCs would not be liable for sales tax on their charges for planning, design, and coordination that are related to the sale of tangible personal property.

Rather, a DMC would be regarded as a consumer of the tangible personal property which they use in performing their destination management services under a qualified contract and tax would apply to the sale of the property to the qualified DMC.

However, if a qualified DMC's contract with its client to provide destination management services does not meet the requirements of "qualified contract," under the provisions of this bill, the DMC for that contract would be regarded as a retailer and would be liable for sales tax on its sales of tangible personal property, including any markups or fees charged by the DMCs for planning and coordination if those charges are related to the sale of the property.

3. **The effect of making these provisions declaratory of existing law.** It is our understanding that it is the author's intent for the bill to have retroactive effect to: 1) eliminate the liability of one DMC audit, and 2) eliminate the liability of several DMCs that have filed amended returns under the sales and use tax amnesty program.

DMC audit. Board staff has identified one potential DMC audit for the period May 1, 2001 through December 31, 2004. The audit is currently being held in the Board's Appeals Division pending the scheduling of an appeals conference. For this DMC, as long as they qualify under the provisions of this bill, the audit liability attributable to any unreported taxable sales of food and beverages, including any markups or

fees charged for planning and coordination related to the sale of the property, would be eliminated.

DMCs that have filed returns under the sales and use tax amnesty program. Board staff has identified 10 event planners that may qualify as DMCs that have filed returns under the tax amnesty program and entered into Amnesty Installment Payment Agreements. For these DMCs, if qualifying, the liability attributable to any taxable sales of food and beverages, including any related markups or fees charged by the DMC for planning and coordination would be eliminated.

For qualified DMCs that have made payments under the tax amnesty program, they could request a refund for those amounts paid. The claim for refund must be filed within three years from the due date of the return on which they reported the tax, or six months from the date of their overpayment.

In addition, if a qualified DMC reported taxable sales of food and beverages, including any related markups or fees charged for planning or coordinating, they would be entitled to a claim for refund of any tax attributable to such taxable sales of property and related fees. However, under Section 6902 of the Sales and Use Tax Law, the statute of limitation period for filing a claim for refund is the latest of the following periods: three years from the due date of the return for the period for which the overpayment was made, or six months from the date of the overpayment. Thus, even though the bill has retroactive application, a qualified DMC would be barred from filing for a claim for refund under the three-year or six month, whichever is later, statute of limitation in Section 6902.

It should be noted that the retroactive application would prohibit the Board from issuing deficiency determinations (billings) to any qualified DMCs that may not have properly reported their sales tax liability. Consequently, the retroactive application would result in a decrease in state and local tax revenues.

4. **As part of the Board's education and outreach efforts, notices were mailed to 80 potential DMCs.** The Board mailed three separate notices (in August 2007, March 2008, and February 2009) informing DMCs of their tax reporting requirements under the Sales and Use Tax Law. The 80 companies were recognized by the ADME as DMCs and other identified large event planners that also offer services referred to as destination management services. The notices discussed some of the services and products offered by DMCs and the taxable nature of the sale of certain products. It also reminded DMCs of their requirement to hold a California seller's permit and report and remit tax due on their sales of items such as meals, food and beverages, t-shirts, and other souvenir items and gifts as part of their contracts for destination management services.
5. **Should other event planners also be treated as consumers of food, beverages, and other tangible personal property furnished by them in the performance of their event services?** Other event planners' business activities are very similar to the activities of DMCs. They also design, coordinate, plan, produce, and manage special events for individuals and groups. These event planners go by many different titles, including conference and meeting planner, convention coordinator, festival organizer, wedding planner, special event or occasion organizer, and trade show planner. The type of services and items they provide varies depending on the event they are planning, and include the following: 1) advertising and marketing, 2) furnishing of food and beverages, 3) planning and providing of entertainment,

decorations, security and parking, 4) coordinating travel, transportation, and hotel accommodations, and 5) hiring, supervising, and training of support staff.

Under current law, other event planners like DMCs are treated similarly to a caterer when providing meals, food and beverages. The event planner is making retail sales of these items and any charges for services related to the furnishing and serving of the food and beverages are subject to tax. Since other event planners' business transactions are very similar to DMCs, should the bill be amended to give them the same tax treatment?

Along the same lines, Board staff notes that the bill would essentially give preferential tax treatment to qualified DMCs. Qualified DMCs would not be liable for sales tax on their retail sales of food and beverages, including any mark ups associated on such sales. DMCs would also not be liable for sales tax on their charges for planning, designing, and coordination that are made in connection with the sale of food and beverages. Consequently, other event planners may believe they are being unjustly treated and may question why legislation was enacted that gave special tax reporting privileges for qualified DMCs over all event planners.

6. **For DMCs, sales and use tax reporting would be simplified; however, bill sets a precedent.** Other businesses have fees and charges for professional services that are related to the sale of tangible personal property and subject to tax. These businesses have to segregate their charges for professional services directly related to the sale of merchandise from charges for services that have no relation to the sale of merchandise.

One such example is interior designers and decorators, who typically perform design, repair, reupholstering, color coordination, and planning. They also sell merchandise such as furniture, window coverings, carpeting, home accessories, and samples. Their professional services typically include consulting, design, layout, selection of color schemes, coordinating furniture and fabrics, and supervising installation. For interior designers and decorators, tax applies to any charges for their professional services that are directly related to the sale of merchandise. Conversely, tax does not apply to charges for professional services that are not directly related to the sale of merchandise.

For these businesses, it's not always easy to determine the point at which their professional services are related to a sale and subject to tax or unrelated to a sale and nontaxable. While enactment of this measure will simplify the DMCs' tax reporting and record keeping, it could set a precedent for other businesses whose business activities also involve nontaxable professional services and taxable services related to a sale.

7. **Suggested technical amendment.** A qualified DMC is defined as spending 1 to 3 percent of its gross revenues annually to market California and local destinations for tourism. Is there a reason for restricting the amount a DMC can spend on tourism to not more than 3 percent? If not, Board staff recommends changing this provision to specify that a DMC expends *at least* 1 percent on tourism. Otherwise, a DMC that spends more than 3 percent would not be treated as a qualified DMC. Board staff recommends the following amendment:

- On page 3, line 7 should read: (E) Expends at least 1 ~~to 3~~ percent of its gross revenue annually to market California and local destinations for tourism.

COST ESTIMATE

Some costs would be incurred in notifying affected taxpayers, revising the Board's regulation and publications, preparing guidelines for both taxpayers and Board staff, and answering inquiries from taxpayers. A cost estimate is pending.

REVENUE ESTIMATE**BACKGROUND, METHODOLOGY, AND ASSUMPTIONS**

This bill would provide that qualified destination management companies (DMCs), as defined, are consumers, rather than retailers, of any transferred tangible personal property. We note that DMCs are a type of a travel service company providing local knowledge, expertise and resources for designing, organizing and implementing events, activities, tours, transportation, and program logistics. This industry appears to be categorized under North American Industrial Classification (NAICS) code 561920, "Convention and trade show organizers."

According to the most recent U.S. Economic Census, in 2002 there were 741 companies in this industry in California, with gross receipts of about \$1.5 billion. The travel industry as a whole has increased receipts by about 31 percent from 2002 to 2007¹.

A recession began in 2008 and has continued so far into 2009. Since travel spending tends to be sensitive to economic conditions, we believe that it would be prudent to estimate 2008 travel spending and forecast 2009 travel spending in order to accurately estimate revenue losses for this legislation. We have no California travel data available to us for 2008, nor do we have forecasts of 2009. It seems reasonable to assume that spending trends in the California travel industry for convention and trade show organizers are closely related to U.S. passenger airline transportation spending. Data from the U.S. Bureau of Economic Analysis indicate that U.S. inflation-adjusted passenger airline transportation spending declined 2.7 percent in 2008. The rate of decline accelerated in the second half of 2008. From the third quarter to the fourth quarter of 2008, U.S. inflation-adjusted passenger airline transportation spending declined at an annualized rate of 13.0 percent.² We estimated the change in California travel spending from 2007 to 2009 by using the annual percent change in U.S. passenger airline transportation spending for 2008 and assuming that the annualized change in the fourth quarter of 2008 will approximate changes in U.S. airline travel spending for all of 2009. Combining the decline for 2008 and the forecast decline for 2009, results in a 15.7 percent decrease in California travel spending for the two years since 2007.

From Board records, we have determined that about 20 percent of DMC receipts are typically derived from taxable sales, most of which are prepared meals. Also from Board records, it appears that a 10 percent taxable management fee (markup) on sales is typical. Under this bill, DMCs would not be taxed on this management fee.

It is impossible for us to determine how many DMCs meet all the requirements specified in this bill. One requirement for which the U.S. Census Bureau have data on are sales

¹ *California Travel Impacts by County*, Dean Runya Associates, California Travel and Tourism Commission, March 2007 and March 2008.

² U.S. Bureau of Economic Analysis, *U.S. Travel and Tourism Satellite Accounts: Fourth Quarter 2008*, March 19, 2009.

by firms with three or more employees. About 96 percent of national sales in NAICS industry 561920 are made by companies with three or more employees. For purposes of revenue estimation, we will assume that all DMCs in California meet this and the other requirements of the bill.

Based on research by Board staff, we believe that there are about 100 DMCs in California in 2007. With the recession, it is likely that this number has declined from 2007 to the present time and there may be further declines during the rest of 2009. In the 2001 recession, data from the U.S. Small Business Administration indicate that the numbers of U.S. employer firms in Administrative and Support and Waste Management and Remediation Services industry with 5 to 20 employees declined by about 10 percent from 2001 to 2002.³ While this is a broader industry group and these are U.S. data, we believe this decline is likely to be representative of California convention and trade show organizers during the current recession. Therefore, we adjusted our estimate from 100 DMCs meeting the requirements of SB 700 (Ducheny) in 2007 to 90 DMCs in 2009. We assume average sales per company for this industry for these 90 DMCS.

Table 1 on the next page shows how the data discussed above were used to calculate DMC receipts subject to taxation under this bill. As shown in the table, we believe that about \$3,979,000 in DMC receipts would no longer be subject to sales and use taxes.

REVENUE SUMMARY

The annual revenue loss from defining DMCs as consumers of taxable items is about \$360,000. Table 2 shows how these revenues are distributed among the various funds.

The bill specifies that this change is declaratory of existing law. Although DMCs are required to hold seller's permits and file returns, Board staff notes that most DMCs have not done so. When a person does not file a return, an eight-year statute of limitation period applies. The average state and local sales and use tax rate in effect just prior to April 1, 2009 is 7.96 percent. Using this tax rate as being representative for this eight-year time period, the revenue loss from this bill would be about \$320,000 per year instead of \$360,000. Therefore, if this bill becomes law there could be one-time losses of up to \$2.6 million in state and local revenues, eight times the annual revenues under the state and local rate prior to April 1, 2009.

³ U.S. Small Business Administration, http://www.sba.gov/advo/research/us98_01_06n_mi.pdf

Table 1	Thousands of Dollars
Estimated Taxable Sales Impacts of AB 676	
California "Convention and trade show organizers," NAICS 561920 ^{1/}	
2002 Receipts	\$1,483,097
Growth Factor From 2002 to 2007 ^{2/}	1.31
Estimated 2007 Receipts	\$1,943,293
Forecast Growth Factor From 2007 to 2009 ^{3/}	0.843
Estimated 2009 Receipts	\$1,638,196
Receipts of 90 of the 741 CA Companies Meet Criteria of AB 676	\$198,971
Percent of Receipts Taxable	20.0%
Taxable Revenues	\$39,794
Ten Percent Taxable Management Fee	\$3,979
<p>1/ Source: 2002 Economic Census, <i>Administrative and Support Services and Waste Management and Remediation Services</i>, Geographic Area Series, California, March 2005, U.S. Census Bureau.</p> <p>2/ Source: <i>California Travel Impacts by County</i>, Dean Runyan Associates, California Travel and Tourism Commission, March 2007 and March 2008.</p> <p>3/ Estimates based on percentages changes in real passenger air transportation, U.S. Bureau of Economic Analysis, <i>U.S. Travel and Tourism Satellite Accounts: Fourth Quarter 2008, March 19, 2009</i>.</p>	

Table 2	Dollars
State and Local Sales and Use Tax Revenues of AB 676	
State	\$248,714
General Fund (6.00%)	\$238,765
Fiscal Recovery Fund (0.25%)	\$9,949
Local (2.00%)	\$79,588
Transit (0.71%)	\$28,254
State and Local (8.96%)	\$356,556

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This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the Board's formal position.